DEPARTMENT OF STATE REVENUE

04-20100682.SLOF

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Supplemental Letter of Findings: 04-20100682 Gross Retail Tax For the Years 2006, 2007, and 2008

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ISSUES

I. Refrigeration Equipment – Gross Retail Tax.

Authority: IC § 6-2.5-1-2; IC § 6-2.5-2-1(a); IC § 6-2.5-2-1(b); IC § 6-2.5-3-1(a); IC § 6-2.5-3-2(a); IC § 6-2.5-3-2(a); IC § 6-2.5-4-1(b), (c); IC § 6-2.5-5-3(b); IC § 6-8.1-5-1(c); Rhoade v. Ind. Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629 (Ind. Tax Ct. 1999); Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282 (Ind. Tax Ct. 1999); Hudson Foods, Inc. v. Indiana Department of Revenue, No. 49T10-9711-TA-192 (Ind. Tax Ct. Oct. 7, 1999); USAir, Inc. v. Ind. Dep't of State Revenue, 623 N.E.2d 466 (Ind. Tax Ct. 1993); General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); 45 IAC 2.2-5-8(b); 45 IAC 2.2-5-8(g); Ind. Tax Ct. R. 17.

Taxpayer argues that the Department of Revenue erred in deciding that its purchase of a "final freezer" was not exempt from sales or use tax.

II. Evaporation Equipment – Gross Retail Tax.

Authority: General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct.1991); Indiana Dep't of Revenue v. Kimball Int'l, Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(j); Letter of Findings 04-20100682 (June 15, 2011).

Taxpayer maintains that its purchase of evaporation equipment was exempt from sales and use tax because the equipment is directly used in the direct production of its food products.

III. Transport Equipment - Gross Retail Tax.

Authority: 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(f); 45 IAC 2.2-5-8(f)(3); 45 IAC 2.2-5-8(h)(2); Webster's II New Riverside University Dictionary (1998).

Taxpayer states that it was required to pay sales tax or self-assess use tax on the purchase of a "bucket elevator" because the elevator is used in the "rendering" of waste products.

STATEMENT OF FACTS

Taxpayer processes and markets chicken, beef, and pork products to its customers. Taxpayer purchases animals from a variety of sources. Upon delivery, the animals are weighed, slaughtered, and processed into one of Taxpayer's food products.

The Department of Revenue (Department) reviewed Taxpayer's records to determine if Taxpayer paid the appropriate amount of sales and use tax. As part of that audit review, Taxpayer and the Department agreed on a "use statistical sampling methodology." The audit resulted in the assessment of additional tax as set out in an audit "Summary" dated September 9 2010.

Taxpayer disagreed with a portion of the assessment and submitted a protest to that effect. An administrative hearing was conducted and a Letter of Findings issued June 2011. Taxpayer disagreed with the findings contained in the June 2011 Letter of Findings and requested a rehearing on the issues. A second administrative hearing was conducted during which Taxpayer's representatives further explained the basis for their disagreement. This Supplemental Letter of Findings results.

I. Refrigeration Equipment – Gross Retail Tax.

DISCUSSION

Taxpayer purchased two "Work in Process" refrigerators and a "Final Freezer." Taxpayer argues that all of the refrigeration equipment is exempt from sales/use tax because Taxpayer "produces and sells a frozen product" and that any of the refrigeration "equipment used to lower the temperature of the product should be considered to be exempt pursuant to IC [§] 6-2.5-5-3."

The Department's audit found as follows:

[Taxpayer's] refrigeration systems consist of [two] work in process coolers and a final freezer. Plant engineers determined that the final freezer makes up 10 to 15[percent] of the total refrigeration load depending on the season and product. Therefore, the auditors and taxpayer personnel agreed to a taxable percent of 13[percent].

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b).

Indiana also imposes a complementary excise tax called "the use tax" on "the storage, use, or consumption

of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC § 6-2.5-3-2(a). "Use" means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a). The use tax is functionally equivalent to the sales tax. See Rhoade v. Ind. Dep't of State Revenue, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

By complementing the sales tax, the use tax ensures that non-exempt retail transactions (particularly out-of-state retail transactions) that escape sales tax liability are nevertheless taxed. Id.; USAir, Inc. v. Ind. Dep't of State Revenue, 623 N.E.2d 466, 468–69 (Ind. Tax Ct. 1993). The use tax ensures that, after such goods arrive in Indiana, the retail purchasers of the goods bear their fair share of the tax burden. To trigger imposition of Indiana's use tax, tangible personal property must (as a threshold matter) be acquired in a retail transaction. Rhoade 774 N.E.2d at 1048. A taxable retail transaction occurs when; (1) a party acquires tangible personal property as part of its ordinary business for the purpose of reselling the property; (2) that property is then exchanged between parties for consideration; and (3) the property is used in Indiana. See IC § 6-2.5-1-2; IC § 6-2.5-4-1(b), (c); IC § 6-2.5-3-2(a).

However, Taxpayer believes the items are exempt from both sales and use tax pursuant to <u>45 IAC 2.2-5-8(b)</u> which states as follows:

The state gross retail tax does not apply to sales of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property. (Emphasis added).

Taxpayer cited to 45 IAC 2.2-5-8(d) as authority for its position that the refrigeration equipment – both the work-in-process coolers and the final freezer – are entirely exempt. The cited regulation states as follows:

Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." Indiana Dept. of State Rev. v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

IC § 6-2.5-5-3 and IAC 2.2-5-8(b) like all tax exemption provisions, are strictly construed against exemption from the tax. Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282, 283 (Ind. Tax Ct. 1999); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629, 636 (Ind. Tax Ct. 1999). Nevertheless, the Department is well aware of the countervailing rule that a "statute must not be construed so narrowly that it does not give effect to legislative intent because the intent of the legislature embodied in a statute constitutes the law." General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991).

As noted above, Taxpayer cites to IC § 6-2.5-5-3 for the proposition that all of Taxpayer's refrigeration equipment is exempt.

[T]ransactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. IC § 6-2.5-5-3(b).

In support of its argument that all of its refrigeration equipment was exempt, Taxpayer cites to Hudson Foods, Inc. v. Indiana Department of Revenue, No. 49T10-9711-TA-192 (Ind. Tax Ct. Oct. 7, 1999) in which the court found that dry ice was "consumed" in the production of the petitioner's poultry meat products. Taxpayer maintains that the disputed refrigeration equipment is "identical to the use of dry ice in Hudson Foods." Taxpayer believes that any equipment used to lower the temperature of Taxpayer's food product is exempt. However, the Department must question whether or not Taxpayer is entitled to cite to an unpublished opinion whether or not the petitioner in Hudson Foods and the Taxpayer are closely related. Ind. Tax Ct. R. 17 states:

All judgments shall be incorporated in written memorandum decisions by the court. Unless specifically designated "For Publication," such written memorandum decisions shall not be published and shall not be regarded as precedent nor cited before any court except for the purpose of establishing the defense of res judicata, collateral estoppel, or the law of the case. Judgment shall be subject to review as prescribed by relevant Indiana rules and statutes.

The Department does not agree that the decision in Hudson Foods is dispositive on this protest because the refrigeration equipment – the "final freezer" – here at issue is used to maintain the temperature of frozen foods once that food has been prepared, and the dry ice at issue in Hudson Foods was consumed in the production of that petitioner's food products.

The June 2011 Letter of Findings concluded that:

The Department is in agreement with audit report's analysis concluding that the final "freezer" is exempt

because it has a direct effect on Taxpayer's food product. The remaining equipment may be "essential" but – except [] to the extent that the audit agreed the "final freezer" was exempt – Taxpayer's refrigeration equipment is not part of the integrated process which produces tangible personal property. See 45 IAC 2.2-5-8(q)

The original Letter of Findings plainly misstated the audit's factual conclusion. The audit concluded that the two work-in-process coolers were exempt and the final freezer was not exempt; the analysis contained within the Letter of Findings was correct but the Letter of Findings incorrectly reversed the factual findings contained with the audit report. The conclusion was correct but statements contained within the Letter of Findings warrant correction.

Nonetheless, the Department finds no reason to disagree with the audit's conclusion the work-in-process coolers were used in the direct production of Taxpayer's food product because the work-in-process coolers have a direct effect on Taxpayer's food products. However, the Department must conclude that the exemption statutes draw a distinction between refrigeration equipment which has a direct and immediate effect and refrigeration equipment which is used to maintain, store, or preserve products when the production of those products has been completed. For example, refrigeration equipment which is used to transform water into marketable ice cubes is likely exempt pursuant to IC § 6-2.5-5-3(b) but refrigeration equipment used to maintain those same ice cubes in their frozen state – such as that found in the ice manufacturer's warehouse or found in a local supermarket – is not exempt.

As noted in the June 2011 Letter of Findings, the Department does not question Taxpayer's assertion that all of its refrigeration equipment is necessary to the production of Taxpayer's food product. However, there is a distinction between equipment which is "necessary" and equipment which is exempt. To that end, it should be noted that the regulation also explains in part as follows:

The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean the property " has an immediate effect upon the article being produced." Instead, in addition to being essential for one of the above reasons, the property must also be an integral part of an integrated process which produces tangible personal property. 45 IAC 2.2-5-8(g). (Emphasis added).

IC § 6-8.1-5-1(c) requires that a taxpayer bear the burden of demonstrating that a proposed assessment is "wrong." Bearing in mind that "all tax exemption provisions, are strictly construed against exemption from the tax," the Department concludes that the June 2011 Letter of Findings analysis contained within the Letter of Findings was correct but that it erroneously misstated the conclusion of that report; the original audit correctly distinguished between refrigeration equipment which was exempt and refrigeration equipment which is "necessary" but was not exempt.

FINDING

Taxpaver's protest is respectfully denied.

II. Evaporation Equipment - Gross Retail Tax.

DISCUSSION

Taxpayer purchased evaporation equipment and related parts which – in its initial protest letter – Taxpayer described as "used to evaporate moisture from the air and [food] product."

The audit report stated that the evaporators are "used as part of the cooling system at [Taxpayer's] plant [and] are used in all air conditioning systems to remove moisture." The audit noted that the evaporators do help to keep moisture out of the plant but disagreed as to the applicability of the exemption stating that "there was no positive causal effect on tangible personal property." The audit found the evaporation equipment was subject to tax pursuant to 45 IAC 2.2-5-8(j) which states as follows:

Managerial, sales, and other non-operational activities. Machinery, tools, and equipment used in managerial sales, research, and development, or other non-operational activities, are not directly used in manufacturing and, therefore, are subject to tax. This category includes, but is not limited to, tangible personal property used in any of the following activities: management and administration; selling and marketing; exhibition of manufactured or processed products; safety or fire prevention equipment which does not have an immediate effect on the product; space heating; ventilation and cooling for general temperature control; illumination; heating equipment for general temperature control; and shipping and loading. (Emphasis added).

In its request for a rehearing, Taxpayer argues that the analysis set out in the June 2011 Letter of Findings was flawed. Taxpayer states, "If any portion of the plant has been determined to be engaged in a cooling process that is exempt, then the evaporations associated with that protest must also be exempt." The June 2011 Letter of Findings to which Taxpayer objects concluded as follows:

While using the evaporators can be an element of the manufacturing process, merely managing or conditioning the air environment of an entire plant, by itself, is not manufacturing. Second, only clearly demarcated areas in which there is active manufacturing that depends on a controlled environment are entitled to the exemption. For example, paint booths or finishing stalls within a plant are such areas. The mere fact that the food processing occurs within an open area of a plant does not mean the evaporators are exempt, unless the size and volume of the manufactured product is so large as to dwarf the plant and render

the whole interior an integral part of the processing facility. In Taxpayer's facility, the evaporators operate to "condition" the environment within that facility rather than a specific, demarcated area within that facility. Letter of Findings 04-20100682 (June 15, 2011).

As noted in Part I above, "In applying any tax exemption, the general rule is that 'tax exemptions are strictly construed in favor of taxation and against the exemption.'" Indiana Dept. of State Rev. v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). Taxpayer asks that the Department conclude that "[i]f the environmental equipment has a purposeful effect on the food product, then it is an exempt part of the production process." However, the Department must respectfully decline that invitation. The Department believes that its interpretation and application of 45 IAC 2.2-5-8(c) is not such a "narrow interpretation" of the exemption that the Department's conclusion ignores "the intent of the legislature embodied in a statute...." General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399, 404 (Ind. Tax Ct.1991).

However, Taxpayer raises an additional issue related to the same evaporation equipment. Taxpayer explains that this equipment is part-and-parcel of the refrigeration equipment addressed in Part I which found that a portion of the Taxpayer's refrigeration units were exempt from sales/use tax because those units had a direct and immediate effect on Taxpayer's food product. Presumably, Taxpayer's "evaporation equipment" consists of compressors, condensers, and the like which – in part – are integral to the function of the exempt equipment. To the extent that Taxpayer is able to delineate the extent to which the evaporation equipment is related to the exempt refrigeration equipment, the audit division is requested to adjust the sales/use tax assessment.

FINDING

Taxpayer's protest is sustained in part and denied in part.

III. Transport Equipment - Gross Retail Tax.

DISCUSSION

Taxpayer repaired and purchased repair parts for a "bucket elevator." Taxpayer argues that the bucket elevator is used in an exempt fashion. In its original protest letter, Taxpayer provided the following rationale:

The bucket elevator is used to transport inedible rendering material from the evisceration/slaughter area to the rending area. In the rendering area, these materials are then rendered down to make various other marketable products.

As authority for its argument, Taxpayer cited to 45 IAC 2.2-5-8(f)(3) which states:

Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process.

45 IAC 2.2-5-8(h)(2) addresses the taxability of replacement parts installed on exempt equipment: Replacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, are exempt from tax.

The June 2011 Letter of Findings contained the following analysis:

Taxpayer produces food products. The production of the food product results in waste materials. The waste materials are moved to another portion of the Taxpayer's facility where the waste materials are "rendered." ("To reduce, convert, or melt down fat by heating." Webster's II New Riverside University Dictionary 995 (1998). According to Taxpayer, it then sells the rendered product. The Department agrees that Taxpayer operates a production process which results in food products. The Department also agrees that Taxpayer operates a "rendering" process which reduces otherwise "waste" meat products into a product which it then sells. However, the Department must necessarily questions whether the two production processes constitute an "essential and integral part of an integrated process that produces the product...." 45 IAC 2.2-5-8(c). The "integrated process" is one where the total production process is comprised of activities or steps that are functionally interrelated and where there is a flow of "work-in-process." 45 IAC 2.2-5-8(c).

Taxpayer again asks that the Department determine that the Taxpayer's food processing process and its rendering process constituted a single "integrated process...." but Taxpayer has produced little additional information which would allow the Department to arrive at such a conclusion. Taxpayer produces meat products which necessarily results in waste meat products which – conveniently enough – are processed in Taxpayer's own rendering plant. However there is insufficient information to allow a departure from the original conclusion that the "bucket elevator" is more properly addressed at 45 IAC 2.2-5-8(f) which states that:

Transportation equipment used to transport work-in-process, semi-finished, or finished goods between plants is taxable, if the plants are not part of the same integrated production process.

The food product and the rendering facilities are apparently under the same roof, but the two activities do not constitute a single "integrated production process."

FINDING

Taxpayer's protest is respectfully denied.

SUMMARY

On Taxpayer's objection that its evaporation equipment is integral to the function of the exempt refrigeration equipment, Taxpayer's protest is sustained in part; Taxpayer is requested to verify the extent to which the evaporation equipment is integral to function of this exempt refrigeration equipment and to supply that information within 30 days of the date on which this Supplemental Letter of Findings is issued. In all other respects,

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Taxpayer's protest is denied.

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